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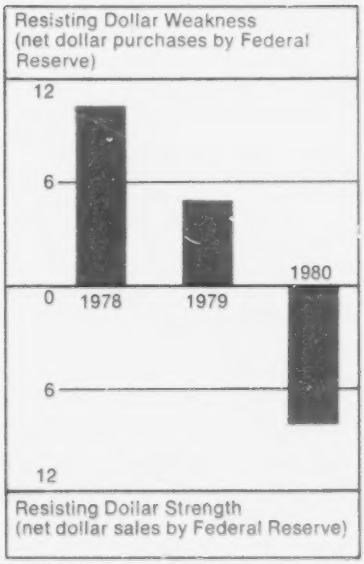
U.S. Foreign-Exchange Intervention Halted

The U.S. Treasury announced a major change in U.S. foreign-exchange intervention strategy last week that should improve the conduct of U.S. domestic monetary policy. The Federal Reserve System--operating through its foreign-exchange trading desk at the New York Federal Reserve Bank--will no longer intervene in the foreign-exchange markets, except in emergencies. This shift should have no effect on the dollar's foreign-exchange value or on worldwide foreign-exchange markets, since the magnitude of U.S. intervention activities has historically been small compared with the total size of actual and potential foreign-exchange transactions. The change should, however, make for a more consistently applied U.S. monetary policy.

U.S. intervention in currency markets

billion dollars



For example, last winter there was a basic conflict in the tactics employed by the Federal Reserve's foreign-exchange desk and the Domestic Open Market Desk. The foreign desk was a net purchaser of foreign currencies--usually German marks--and thus a supplier of dollars to world money markets. The domestic desk, which operates in volumes many times the size of the foreign desk, was attempting during this same period to constrain the growth of the money supply. Thus, the domestic desk consistently offset the impact of the foreign desk's transactions on world money markets.

This inconsistency in basic operations by the Federal Reserve has been addressed in the intervention strategy imposed by Treasury Undersecretary Sprinkel. If the United States adopts a fundamentally more restrictive monetary policy than its trading partners, policymakers should anticipate that the dollar will strengthen. To resist this dollar strength through market intervention is fruitless even when this intervention is carried out on a day-to-day basis with the objective of reducing exchange-rate volatility.

The presumed basis for the new strategy is the proposition that foreign-exchange markets are linked closely to domestic money markets. Indeed, most international banks locate their foreign-exchange and money-market dealers in the same trading room with access to the same information, which they can share. This makes for extremely efficient markets that are tightly linked. With the new intervention strategy, the Treasury has acknowledged that attempts to play one market against another are not viable operational strategies for the Federal Reserve.

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Denmark's economic improvement may be short-lived.

Denmark's proclivity for stretching its resources and piling up huge foreign debts persists, but recent developments point to some improvement in the domestic economy. Last year's trade deficit narrowed to $2.4 billion from $3.6 billion in 1979, and preliminary deficit figures for January and February 1981 were below those for the same two months in 1980. The rate of inflation, which threatened to exceed 14% for much of 1980, has been kept to 10% since the fourth quarter of last year. Moreover, recent private-sector wage negotiations suggest that earnings will rise by some 7% this year and next, thereby holding Denmark's costs in line with those of its trading partners. Looking further ahead, North Sea gas is expected to supply 30% of Danish energy needs by 1984 and a larger proportion thereafter. Nonetheless, the near-term outlook is less encouraging. The trade deficit remains large, and overseas debt is growing rapidly. In addition, much of the recent improvement in the deficit and inflation has been bought at the expense of a deep recession. As time passes, the pressure on the government to stimulate the economy is likely to intensify—which will then aggravate key economic indicators.

New Dutch measures aim to boost investment and exports.

In an attempt to direct resources away from consumption toward investment and exports, the Dutch government last month announced cuts in government spending, more aid to industry, and higher fuel and social insurance taxes. Total government spending is to be reduced over previous plans by 2.5% to 4 billion guilders for the year, and higher excise taxes on gasoline and diesel fuel will raise an additional 250 million guilders in revenue. Special aid will be channeled to the building industry, firms in financial difficulty, and the unemployed young. On balance, the measures should cut the government's financing deficit to 6.75% from 7.5% and dampen consumer spending by 3%-5%. These measures, together with the higher prices for Dutch gas exports negotiated last year, should help reduce the 1981 current-account deficit from the 4.9-billion-guilder ($2.3-billion) gap recorded last year.

Current-account deterioration to accompany Greece's economic rebound.

Despite a slowdown in economic growth, Greece's balance-of-payments gap expanded last year. Real GDP growth was only 1.3% in 1980, versus 3.9% in 1979, yet the current-account deficit widened to $2.06 billion from $1.88 billion the year earlier. The major cause was a $1-billion rise in net oil imports to some $2.7 billion, without which the current account would have shown substantial improvement. Non-oil imports actually declined by 2% in value and by substantially more in volume. A reflationary budget and some easing of monetary policy are officially expected to lift the rate of real economic growth to about 2.7% this year and to push the current-account deficit to some $2.4-$2.5 billion. The latter range might prove optimistic, however, if expectations of a $3.6-billion annual oil bill are fulfilled. The inflation rate, currently about 26%, is officially projected to decline to approximately 21% by yearend. The outlook beyond yearend, however, is clouded by uncertainty regarding the outcome of the forthcoming elections—due by November—and the policies that the new government will pursue.

Flurry of Panamanian investment projects buoying local economy.

The recently brisk pace of Panamanian economic activity stems largely from a number of major projects either planned or under way. The new development plan being prepared stresses projects that exploit more fully the country's resources and geographic location. In the energy field, three major hydroelectric facilities have either been completed or launched, while plans are set to extend electrification to rural areas now without electricity. Another major investment planned is the building of a Trans-Isthmus pipeline to transport oil from the Pacific to the Atlantic coast of the country. These projects supplement the recently constructed international airport, fishing port, and convention center. Together, all of the ongoing and planned projects should have multiplier effects sufficient to assure real economic growth of 5% or more in 1981.

Peru's economic growth rate eased some in 1980.

The Peruvian economy recorded real growth of 3.1% in 1980, down slightly from the 3.8% recorded in 1979. The small deceleration was the product of a 5.5% decline in agricultural output, owing to poor weather, and a 3% drop in mining's contribution, attributed to the disincentive of low world mineral prices and to strikes. Manufacturing and construction performed well, however, rising by 7% and 18%, respectively, compared with growth of about 3.8% each in 1979. The rate of inflation equalled 60% last year, on a fourth-quarter-to-fourth-quarter basis, a rate that has been sustained so far this year because of adjustments in food and fuel prices and interest rates, wage increases, and continued expansionary monetary and fiscal policy. In the external sector, the shift to import liberalization, aimed at checking inflation, raised imports to $3 billion from $1.9 billion in 1979. With exports rising only moderately to $3.9 billion from $3.5 billion the year earlier, Peru's trade surplus declined to $825 million last year.

Korean economic recovery under way.

Korea's economy now appears to have turned the corner after a tumultuous 1980. The country registered negative real economic growth of 5.7% last year, accompanied by an inflation rate of 35% and extreme political turmoil. President Chun Doo-Hwan's government, which won a solid electoral mandate recently, is committed to leading the country on the road to renewed takeoff. Various government initiatives designed to boost domestic and international confidence in Korea are having notable psychological effects, but actual economic benefits must await an upturn in world trade and a further decline in inflationary pressure. Meanwhile, heavy import requirements associated with the economic recovery will keep the current-account deficit large. External borrowing needs will thus continue high, at about $7 billion. Overall, Korea is likely to see real economic growth of 5%-6% this year and an easing of the inflation rate to about 20%.

UAE current-account surplus widened by more than 65% in 1980.

The United Arab Emirates, an OPEC member, registered a current-account surplus of an estimated $9.5 billion in 1980, up sharply from approximately $5.75 billion in 1979. The marked improvement—attributable to Abu Dhabi and Dubai, which account for virtually all oil production in the UAE federation—occurred despite a cut of 7% in Abu Dhabi's oil output last year to an average of 1.7 million barrels per day. It reflected a 59% increase in the weighted average sales price of UAE oil, which rose from about $19.70 per barrel in 1979 to $31.40 per barrel last year. Export revenue was up 48% in 1980, totaling $20.2 billion, fueled mainly by gross oil revenues of $19.4 billion. At the same time, imports of goods (not re-exported), services, and private—as well as official—transfer payments rose 40% to some $13.5 billion, reflecting a pick-up in domestic economic activity. Finally, non-oil earnings of approximately $2¾ billion—mainly from foreign assets—brought the overall current-account surplus to $9.5 billion. The probability is high that the UAE surplus will narrow significantly this year in view of sluggish demand for OPEC oil, the likelihood that official oil prices will remain stable over the remainder of the year, and a continued expansion in imports.

Reduced feed grain supplies imply price rises in second quarter.

Prices of coarse or feed grains look set to rise during the second quarter of 1981. It is estimated that world coarse grain supplies for the 1980-81 crop year will be about 808 million metric tons, the lowest since 1977-78. Increasing commitments by many countries to expand livestock production suggest consumption of 750 million tons in 1980-81. As a result, coarse grain stocks are projected to be about 62 million metric tons at the end of 1980-81, equivalent to only 8.4% of utilization. This compares with ending stocks of 88 million tons in the crop year 1979-80 and with a previous low stock-utilization ratio of 8.8% recorded in 1975-76. The price of No. 2, Yellow, Chicago corn—corn accounts for roughly 65% of total coarse grain supplies—is likely to average around $3.85 per bushel in the second quarter of this year, compared with an average price of $3.50 for the first quarter. These prices are well above the 1980 average of $3.01 per bushel.

Recent Money Bulge May Be Reversed

Growth in one of the most widely watched measures of the money supply has surged over the course of recent weeks. In the four weeks ended April 8, M1-B grew at a seasonally adjusted annual rate of 13¾%. And from March 25 to April 1, M1-B rose a whopping $8.1 billion. Such growth, if sustained, could portend a sizable rise in money-market rates in the near future. There is reason to believe, however, that much of the recent jump in M1-B is the result of technical seasonal-adjustment problems that will soon be reversed.

M1-B consists of currency, demand deposits, and "other checkable deposits"—such as NOW accounts—at banks and thrifts. To arrive at seasonally adjusted M1-B, each component is seasonally adjusted individually—except for other checkable deposits. This is presumably because there has not been enough experience with this component to permit a scientific estimation.

The potential magnitude of the effect uncaptured seasonal movements in other checkable deposits may have on M1-B growth has increased significantly since January, when NOW accounts were introduced nationwide. Since last December, other checkable deposits have risen from $27 billion to $63 billion, or from 6½% to 15% of M1-B. If seasonal movements in these deposits are similar to the wide seasonal fluctuations in demand deposits, such movements could have a profound impact on short-run M1-B growth.

The Federal Reserve's seasonal factors suggest that seasonal forces cause unadjusted demand deposits to rise by 5.1% between March 25 and April 8. If 60%-75% of other checkable deposits behave similarly to demand deposits—a reasonable assumption, given Fed estimates—then these seasonal factors suggest that a seasonal rise in other checkable deposits woud push up M1-B between March 25 and April 8 by about $2 billion. In actuality, other checkable deposits rose $6.1 billion during these two weeks.

The above seasonally adjusted estimate probably *understates* the actual seasonal component of other checkable deposits. Almost all such deposits are held by households, and the seasonal rise in household deposits in April is traditionally larger than that of total demand deposits—by about 2.2%. This implies that the seasonal rise in other checkable deposits from March 25 to April 8 was closer to $2½ to $3½ billion. It also suggests that the failure to seasonally adjust other checkable deposits may add as much as 3½ to 8½ percentage points to annualized M1-B growth in April.

Households, however, tend to run down their demand-deposit holdings from mid-April to May about as fast as they run them up from mid-March to mid-April. Consequently, any *seasonal* rise in "other checkable deposits" in April should be completely reversed by mid-May.

Investment Aids GNP Surge

Strong business investment was a major contributor to the surprising 6.5% rise in real GNP reported by the Department of Commerce for the first quarter of 1981. Only last month, Commerce had projected a 5% climb in GNP, and some analysts had expected a weaker figure because March retail sales rose only 0.1%, despite booming auto purchases. But strong investment by business in the first quarter—more than 12% growth at an annual rate—helped pave the way to a larger GNP increase.

The recession last year was brief but extremely sharp, leading to a fall in GNP that was just about as severe as the average decline for post-war recessions. But the drop in investment spending was only about two-thirds as steep as the drop in investment accompanying the average business downturn. And investment's rebound in the last six months has been considerably stronger than expected.

The briefness of the recession has contributed to the strong investment performance. The five previous recessions lasted, on average, nearly twice as long as the 1980 downturn. With reduced cash flow over such an extended period of time, businesses were forced to cut back spending quite sharply. But with the quick turnaround of the economy last year, there was little need for businesses to interrupt their spending plans on a massive scale.

The strength in investment, however, has not been broad-based. The buoyancy of first-quarter investment is entirely attributable to greater purchases of autos (in response to manufacturers' rebates), office and commercial construction, and equipment and furnishings for these stores and offices. These three components have skyrocketed at an annual rate of 30% over the last two quarters, while investment in all other sectors has posted a meager 1% increase—about half the pace of previous recovery periods. Indeed, many sectors are still seeing declines in investment. Even the booming petroleum sector, where investment rose by more than 20% during 1980, suffered a setback in the first quarter as oil company profits tumbled.

The improvement in the economy and in profits that followed the 1980 recession was limited, however. Industrial investment growth remained slow, owing mainly to weak profits, which in turn reflected a relatively low level of capacity utilization. The increase in manufacturing profits since last summer has been chiefly the result of smaller losses by the automakers and their suppliers; profits in virtually every other industry are still below year-ago levels. And with capacity utilization still below 80%, there is little incentive to increase investment.

Without a resurgence of industrial investment, the recent strength in total investment is unlikely to be sustained. A tax reduction for businesses, via accelerated depreciation, may spur some speed-up in business investment plans, but a healthier operating rate is essential for any sustained investment increase.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars April 22, 1981	change from year earlier	current monetary conditions	
Argentina	Important new tax, tariff, and currency measures taken to promote exports and spur local output.	Dec.	+ 3%	117.0	$4,333	Dec.	6,719	— 26%	8.9	0	Argentine peso devalued by 22.8%.	Mar.	+ 82%	Nov.	+ 99%	.00040	— 29%	High interest rates begin to decline.	Argentina
Bahamas	Slow economic growth in U.S. and Europe contributes to decline in tourist arrivals.	Feb.	— 4%	1.2	5,630	Feb.	98	+ 12%	0.1	0	Foreign real estate investment falls.	Dec.	+ 12%	Dec	— 1%	1.01	+ 10%	Central bank stresses domestic business loans.	Bahamas
Barbados	Government budget for 1981-82 includes large increase in capital spending.	Aug.	+ 67%	0.8	3,055	Feb.	77	+ 14%	1.8	3	Tourist arrivals fell slightly in 1980.	Nov.	+ 15%	Jan.	+ 16%	.5200	+ 5%	Prime rate rises from 8% to 10%.	Barbados
Bolivia	Agreement reached on rescheduling $420 million due international commercial banks by April 1983.	Oct.	+ 21%	6.1	1,100	Feb.	138	+ 11%	1.8	77	Gross foreign reserves fell by 40% + in 1980 to $106 million at yearend.	Dec.	+ 24%	Dec.	+ 44%	.0425	+ 4%	Liquidity squeeze in evidence.	Bolivia
Brazil	Industry slows down as demand responds to restrictive money, credit, and fiscal measures.	Feb.	+ 29%	237.2	1,991	Oct.	5,568	— 39%	2.6	0	New 15% tax subsidy granted manufactured exports.	Mar.	+ 121%	Feb.	+ 68%	.0135	— 35%	Foreign loan inflows grow strongly.	Brazil
Chile	CORFO intends to sell seven subsidiaries and one bank to private sector.	Nov.	+ 9%	22.8	2,060	Feb.	3,124	+ 46%	6.1	107	Capital inflows respond to large interest differentials and fixed exchange rate.	Feb.	+ 29%	June	+ 65%	.0256	0	Syndicated dollar loans on rise.	Chile
Colombia	Mining sector—gold, emeralds, coal, nickel—assuming more importance in the economy.	Dec.	— 11%	36.8	1,360	Feb.	4,761	+ 19%	12.6	0	Book and magazine exports supplement coffee earnings.	Dec.	+ 26%	Dec.	+ 28%	.0190	— 13%	Local credit availability improves somewhat.	Colombia
Costa Rica	Authorities plan to increase irrigation network and improve highway system.	Dec.	+ 2%	5.0	2,190	Feb.	102	+ 14%	0.8	54	Six-month, interest-fee import deposit plus 1% import surcharge imposed.	Dec.	+ 18%	Dec.	+ 17%	.0750	— 36%	Monetary policy is restrictive.	Costa Rica
Ecuador	Oil production rate up to 225,000 barrels daily as result of new producing fields.	Dec.	+ 14%	9.2	1,100	Feb.	803	+ 3%	4.1	0	Monetary reserves decline because of larger debt payments.	Mar.	+ 14%	Jan.	+ 28%	.0375	— 6%	Credit restraint spurs higher interest rates.	Ecuador
El Salvador	Real GDP in 1980 estimated to have fallen about 9% because of political turmoil.	Sept.	+ 3%	3.8	780	Feb.	92	— 7%	1.1	7	U.S. plans $126-million loan as net reserves approach minus $100 million.	Dec.	+ 19%	Jan.	+ 3%	.4025	+ 1%	Liquidity is tight.	El Salvador
Jamaica	Government undertaking stabilization program within context of an $700-million IMF arrangement.	Nov.	+ 26%	3.2	1,460	Jan.	121	— 4%	1.2	297	Some imports channeled to "parallel" foreign-exchange market.	Nov.	+ 30%	Oct.	+ 55%	.5700	+ 2%	Credit policy is restrictive.	Jamaica
Mexico	Oil production level of 2.6 million barrels daily makes Mexico number four in world output.	Dec.	+ 64%	167.0	2,300	Sept.	2,603	+ 38%	1.4	0	Investments in U.S. border industries increase.	Jan.	+ 28%	Dec.	+ 33%	.0418	— 4%	Short-term peso loans at 28%-30%.	Mexico
Nicaragua	Commerce and construction posted large gains in 1980; repeat peformance expected this year.	Dec.	— 17%	1.8	695	Nov. '79	85	+ 42%	4.5	47	Cotton production projected to rise 30% in 1981.	Dec. '79	+ 68%	Aug. '79	+ 55%	n. a.	—	Credit limits set by industry category.	Nicaragua
Panama	Construction of Trans-Panama oil pipeline between Pacific and Atlantic coasts planned.	Oct.	+ 22%	3.5	1,805	Jan.	82	— 28%	0.7	37	Additional IMF credits granted.	Jan.	+ 15%	Dec.	+ 10%	Par	—	Offshore banking activities increase.	Panama
Paraguay	Large new bridge planned to link Paraguay with Argentina over the Parana River.	Nov.	+ 5%	4.6	1,505	Feb.	746	+ 23%	13.9	0	Trade with Brazil steps up.	Nov.	+ 11%	Nov.	+ 18%	.0080	0	Local loans limited.	Paraguay
Peru	Contract signed with Superior Oil for exploration and development in northern jungle.	Sept.	0	17.2	965	Nov.	1,922	+ 63%	8.2	433	Current-account gap of $68mn. in 1980, versus surplus of $710 mn. in 1979.	Mar.	+ 58%	Nov.	+ 55%	.0026	— 28%	Money growth continues at fast pace.	Peru
Uruguay	Central bank announces devaluation schedule through Sept.—to be supported via intervention.	Dec.	+ 23%	8.9	3,025	Dec.	473	+ 24%	3.6	0	Foreign reserves at $1.2 billion, with capital inflows heavy.	Dec.	+ 43%	Sept.	+ 32%	.0990	— 13%	Interest rates declining.	Uruguay
Venezuela	First major contract in Orinoco Heavy Oil Belt awarded.	Nov.	+ 22%	51.4	3,690	Feb.	7,008	+ 6%	7.7	0	Authorities believed to be planning to raise $3-$4-billion Euromarket loan.	Jan.	+ 21%	Oct.	+ 17%	.2335	0	Credit availability limited.	Venezuela

World Interest Rates

market rates of Apr. 22, 1981; bond yields as of Apr. 17, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty large banks 16.00	17.16	12.00	15.00	9.50	7.50	19.00 penalty rate 22.00	9.00	4.00	6.25
Day-to-Day Money	15.75 Apr. 23	18.00	12.00	15.75	12.25	11.25	19.75	10.00	5.75	7.1875
Treasury Bills 91-day, Middle Rates	13.55	16.95	11.28	17.25	13.69 one-year	n. a.	17.60 99-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.25 finance paper	17.35 finance paper 15% tax w/h	11.31	14.90 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.75	17.30 15% tax w/h	11.56	14.90 Certified	not traded	9.90	21.65	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	13.56	14.75	13.69	12.315 20% tax w/h	14.295	10.07	18.38	11.30	5.45	7.801*
Industrial Bonds prime, long-term, new and old issues, average yield	13.95 Aa Industrials	15.50	14.47	18.728	15.45	10.34	18.87	11.99	6.256	7.06*
Bank Short-Term Rate to Best Borrowers (prime rate)	17.50	18.25	13.00	19.25	14.35	13.75	22.50 ⅛ quarterly fee on outstdng.	12.00	8.00	6.75
Bank Time Deposits 3-month	14.75 Cert. of Dep.	16.75	12.375	17.10	13.25	13.15	10.75	10.50 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.3125	no market	12.375	no market	12.6875	12.50	no market	10.5625	9.0625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8361	2.1800	.0282	.1949	.4613	.000923	.4153	.5050	.004603
Forward Exchange Cover 3 month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *D*	3.875 *P*	1.125 *D*	2.625 *P*	3.50 *P*	3.375 *D*	5.50 *P*	7.00 *P*	8.75 *P* *

Eurodollar Deposits
(London, interbank, bid)
April 22

7-day	15.625
1-month	15.00
3-month	16.25
6-month	16.125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.452
U.S.-Canada Treasury Bills	−1.22
U.S.-Canada Finance Co. Paper	−1.612
Eurodollars-U.K. Local Auth. Deposits	+ .125

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.75
Over 7 yrs.	14.50
DM Bonds	
7 yrs. and under	10.25
Over 7 yrs.	10.00

Gold Price
London afternoon fixing
501.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Bond yields as of April 10.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.6 (Mar.)	12.4 (Mar.)	12.6 (Mar.)	12.7 (Feb.)	5.5 (Mar.)	20.1 (Mar.)	6.3 (Mar.)	6.5 (Feb.)
Industrial production*	−0.3 (Mar.)	−0.5 (Jan.)	−9.3 (Feb.)	9.6 (Feb.)	2.0 (Feb.)	3.6 (Feb.)	1.0 (Dec.)	0.1 (Feb.)
Trade balance† *(billions of local currency units)*	−$3.15 (Feb.)	C$0.54 (Feb.)	£0.31 (Feb.)	−FF4.61 (Mar.)	DM0.86 (Feb.)	−Lit.1,530 (Feb.)	−SF0.80 (Mar.)	¥449 (Mar.)
Money supply (M1)*	7.7 (Mar.)	6.7 (Jan.)	5.9 (Dec.)	11.1 (Nov.)	5.8 (Jan.)	13.7 (Nov.)	−5.7 (Nov.)	1.8 (Dec.)
Velocity of money (M1)*	4.6 (Dec.)	−0.14 (Dec.)	8.7 (June)	n. a.	0.6 (Dec.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold *($ million, change from previous month)*	1,370 (Feb.)	79 (Feb.)	−152 (Feb.)	912 (Feb.)	1,759 (Feb.)	1,464 (Feb.)	672 (Feb.)	249 (Feb.)

* Percent change from 12 months earlier.
† Figures are only for the month indicated.

Spanish Economy in Low Gear

The Spanish economy is faced with rough going again this year after an anemic performance in 1980. Real economic growth last year was a scanty 0.5%-1.0%. The only bright spot was agriculture, where output was of bumper proportions. Otherwise, industrial output declined 1% over the first nine months of the year, and tourist arrivals as of November 1980 were down 1.3%—in response to high prices and the threat of terrorism. Aggregate demand was especially weak in the face of a surge in unemployment. Only public consumption was strong, at the cost of a steadily expanding budget deficit.

Things are unlikely to improve this year. The domestic economy is languishing, with agricultural output hurt by drought and investment spending curtailed by political uncertainty. The public-sector deficit continues to swell, renewed price pressures have emerged, and unemployment remains precariously high. The external economy is also in difficulty. The balance of payments is in substantial deficit, and worldwide recession will dampen exports at least through midyear. Meanwhile, the peseta continues to depreciate steadily and rapidly on the foreign-exchange markets. All in all, real economic growth in excess of 1.0%-1.5% appears unlikely in 1981—despite the expansionary impact of the ever-widening public deficit.

A budget deficit out of control

Spain's growing public-sector deficit constitutes a serious fundamental problem, which the authorities have yet to address in earnest. The 1980 budget gap totaled 315 billion pesetas (about $4 billion), nearly double the 1979 shortfall and equivalent to some 2% of GNP. The 1980 deficit was partly the product of recession, as revenues registered a 2.5% decline. But the major culprit was broad-based overspending, a pattern that appears unlikely to be reversed.

The widening deficit also played havoc with the domestic financial market late last year. World financial markets were already in upheaval with U.S. dollar interest rates at record levels. The combination of a weakening peseta and high dollar interest rates thus led to a flow of funds out of Spain and an easing in the fast pace of money supply growth—to 16% in December from 17.8% in September. With declining liquidity and rising public demand for funds, interest rates rose and private borrowing tended to be crowded out. Although the monetary authorities have moved to liberalize the domestic financial system—by abolishing interest-rate ceilings on most credits, freeing interest rates for deposits of more than six months' maturity, and clarifying rules on bank commissions—Spain's still-rigid financial system, a holdover from the Franco era, remains far from liberalized.

The rapidly depreciating peseta, together with imported-fuel price increases and rising food prices, has touched off renewed price pressures in the Spanish economy. The year-over-year rate of price increase was 14.4% in January, and although official forecasts call for a reduction in the rate of inflation to 13.5% in 1981, this appears overly optimistic given the still-high rate of money growth and the peseta's weakness.

Wages have managed to keep up with inflation, despite the sharp deterioration in the employment situation. Preliminary estimates place the growth of inflation-adjusted wages at about 1% in 1980. Nonetheless, over the same period, the number of unemployed Spaniards jumped 350,000 to 1.5 million—or 12.6%, the highest unemployment rate in Europe.

On the external front, the balance-of-payments reversal has been dramatic. Ironically, it was only in April 1979 that measures were taken to liberalize imports to reduce heavy capital inflows. But the steep oil price rise of 1979-80 hit hard. Preliminary figures show that the current-account balance deteriorated by $6 billion over the course of 1980, leaving Spain with a deficit of $4.8 billion for the full year. The oil bill increased by $4 billion to $12 billion; at the same time, export volume growth was a weak 1%, owing to lagging foreign demand, while imports grew 3%, partly in response to the still-effective 1979 liberalizations. And tourist receipts failed to post increases. The peseta weakened in response to the external-account worsening, declining 16.5% against the U.S. dollar in 1980 (13.2% on a trade weighted basis). This weakness has continued into 1981, with the peseta slipping in line with the German mark.

Spain's long-term prospects are favorable, owing to its strong and diversified resource basis and because of its imminent membership in the European Economic Community. Moreover, although it is expected to remain dependent on imported oil, Spain should be able to finance its balance-of-payments shortfalls without incurring a debt-servicing problem.

The short term, however, offers little cause for optimism. The peseta's depreciation has improved the competitiveness of Spanish exports and has bolstered tourism. But any export-led recovery is not likely to be significant until the world recession begins to reverse itself—possibly in the second half of the year. In any event, the balance-of-payments deficit is not expected to be reduced in 1981. This will keep the peseta weak and contribute to sustaining high inflation. Domestically, there is no sign of any upturn, and political instability is likely to delay any incipient upturn.

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Prime-Based Euroloans

New to Eurocurrency market financing is the syndicated loan that is priced at a spread over U.S. bank prime, rather than over the London Interbank Offered Rate (LIBOR). Borrowers must pay a spread over U.S. bank prime that is adjusted daily or weekly, rather than every three or six months, as it would be in a three- or six-month LIBOR-keyed loan. To protect borrowers and lenders from major deviations between the prime rate and market rates–since the prime is bank-administered rather than market-determined–there may be a negotiated "cap" and/or floor on the maximum allowable spread above or below 90-day certificate-of-deposit (CD) rates, adjusted for reserve requirements.

Euromarket *lenders* are likely to be amenable to the prime-based pricing option. From their perspective, the issue is whether prime-based pricing introduces a greater risk between pricing and funding costs. A major Eurobank may choose to fund a prime-based loan with Eurodollars. If the spread between three-month Eurodollars (interbank) and prime shifts, the lender reaps the gain or absorbs the loss. Prime has historically been higher than LIBOR–reflecting the reserve requirements on U.S. bank deposits–so that spreads over prime are lower than spreads over LIBOR. Even with narrower spreads, however, prime-based loans do provide lenders a small premium for bearing increased funding-cost risks.

The incentives are perhaps strongest for U.S. regional-bank lenders, which are not active participants in either the foreign-exchange or London interbank markets. These banks cannot always fund in the London interbank market on the same fine terms as the larger Eurobanks, but they do have access to competitive funding in the U.S. domestic market. Indeed, prime-based loans are ideally suited for these banks since they are already accustomed to pricing loans on a prime-rate basis.

Borrowers assume some added risks with prime-based, as opposed to LIBOR-based, credits, but these are offset by the opportunity to tap U.S. regional banks as an incremental funding source. Essentially, the borrowers' risks are concentrated in the predictability of the prime-LIBOR relationship. If the loan has a cap option, such that the loan rate can diverge only so much from U.S. CD rates, this risk is substantially reduced. In general, the major risk associated with prime-based Euroloans is that additional reserve-requirement regulations may be imposed on domestic U.S. banking versus Eurobanking–which would result in prime-based loans being more costly than those tied to LIBOR. The Monetary Control Act of 1980 set a trend toward reducing reserve requirements on U.S. banking, but the trend was upset with the temporary imposition of marginal-reserve requirements on bank-managed liabilities in the spring of 1980. There is, however, at least the possibility of costly regulations being imposed on Euromarket activity also. In either case, syndicated loan agreements specify that the borrower bears the risk. Finally, an intangible, but perhaps equally important, advantage of prime-based loans for certain borrowers is the symbolic or psychological value of lower spreads.

All in all, the prime-based loan pricing option is essentially a response to the need of regional U.S. banks–particularly the smaller regionals–for a pricing mechanism more closely reflects their usual asset/liability-management practices. Thus, the success or failure of these new loans will depend upon whether they attract additional regional-bank participation in Euroloan syndications.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IQ/80	IIQ/80	IIIQ/80	IVQ/80	1978	1979	1980
Gross Size (Claims)	1,117.4	1,206.0	1,247.8	1,275.0	893.1	1,110.7	1,275.0
Net Size (Claims)	675.0	745.0	775.0	785.0	535.0	665.0	785.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	274.3	279.9	282.8	285.6	222.3	269.5	285.6
Liabilities to Private Nonbank Foreigners	67.7	69.8	71.9	74.9	57.8	65.8	74.9
Total Claims on Foreigners	324.8	347.3	365.0	381.8	281.8	324.0	381.8
Claims on Foreign Public Borrowers	40.9	41.5	45.7	48.4	34.3	41.7	48.4
Claims on Foreign Private Nonbank Borrowers	118.8	129.4	133.3	138.8	104.1	117.9	138.8

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.